**PROTOCOL BETWEEN THE SCOTTISH GOVERNMENT AND SCOTTISH LOCAL AUTHORITIES: ADMINISTRATIVE ARRANGEMENTS TO BE PUT INTO PLACE SHOULD A UK LIMIT BE PLACED ON LOCAL AUTHORITY BORROWING**

## Introduction

1. This protocol sets out the administrative arrangements to be followed in the event HM Treasury requires a limit to be applied to the level of local authority borrowing in Scotland.

## Background

2. HM Treasury is able to control borrowing through its management of central government budgets, including those of the devolved administrations. They could decide to use their existing powers to impose a limit on public sector borrowing as part of public sector debt 'for national economic reasons'. Such a limit on borrowing would be used to protect the country's economic interest if local borrowing, albeit prudent locally, were considered to be unaffordable nationally.

3. The Scottish Government is required to make returns to HM Treasury on the level of capital expenditure forecast to be undertaken by local authorities for a rolling three year period, and how this is to be financed. The return made to HM Treasury uses the data collected from Scottish local authorities on the capital returns. HM Treasury use this data, together with other data collected, to monitor the levels of borrowing being forecast and considers whether borrowing needs to be constrained. The Scottish Government recognises that the imposition of a limit will disrupt the medium term plans of local authorities, and has emphasised to HM Treasury the importance of providing an early warning of the possibility of a limit being imposed.

4. The borrowing to be controlled by a national limit is the debt element of the 'financing' of capital expenditure and not actual external borrowing. The exception to this is the borrowing undertaken by local authority controlled companies, where the net movement in external borrowing is the value to be considered. The limit on borrowing will therefore apply, in any financial year, to:

- The gross value of advances from the loans fund to finance General Fund capital expenditure;
- The gross value of advances from the loans fund to finance HRA capital expenditure;
- The gross value of advances from the loans fund to finance grants or loans to third parties for capital expenditure (borrowing to fund these may only be undertaken where Scottish Ministers have provided their consent to this borrowing (consent to borrow))
- Long term liabilities recognised in the year which finance capital expenditure such as PPP/ PFI or similar arrangements, but only where these arrangements would be on-balance sheet if ESA 95 is applied;
- Any finance lease liability recognised in the year to finance capital expenditure, and;
- Any net increases in the external borrowing of local authority subsidiaries.

### *Loans Fund Advances*

5. Loans fund advances may be financed either through external borrowing, or internal borrowing through the investment of reserves in the loans fund. With the exception of borrowing under the consents agreed with HM Treasury and described above, the national limit will apply to **all** loans fund advances and is not restricted to those advances financed by external borrowing.

### *Consent to Borrow*

6. Under provisions contained in the Local Government (Scotland) Act 1975 Ministers may consent to a local authority borrowing for expenditure which the local authority would not otherwise be able to finance by borrowing. For non-capital related items such as equal pay or severance Scottish Ministers may only consent to a local authority borrowing within limits agreed with HM Treasury. As these limits have been agreed with HM Treasury this borrowing will not be included in any national limit. For capital related items – such as grants to third parties to support capital expenditure – HM Treasury do not place any limits on Scottish Ministers. This borrowing will be the subject of any national borrowing limit.

### *ESA 95*

7. With the move to International Financial Reporting Standards ("IFRS") the accounting for PFI and similar transactions changed. However, for National Accounts, the accounting treatment did not change, creating a divergence of treatment from 1 April 2009.

8. UK budgets must follow National Accounting standards, these standards are laid out in Part IV of the Manual on Government Deficit and Debt ("MGDD")2 (that provides guidance on the application of the European System of Accounts 1995 ("ESA 95")), and technical guidance issued by HM Treasury (issued 2 September 2009).

9. This means that, for budgeting purposes, HM Treasury do not recognise debt or liabilities which would not be recognised if the standards set out in ESA 95 are not met. This in turn means that debt or liabilities arising from PFI or similar transactions which are not debts or liabilities in the National Accounts are not subject to any limits that may be placed on local authority borrowing. Any limit placed on local authority borrowing will not apply to any PFI or similar arrangement which would not be on balance sheet if the ESA 95 standard is applied.

### *Supported Borrowing*

10. A Local Government settlement may include supported borrowing. A notional amount of capital expenditure will be supported by the Scottish Government by providing revenue grant each year to finance debt incurred by local authorities in financing the notional amount of capital expenditure. The support for this borrowing is the cost of the debt charges i.e. interest, the statutory charge representing repayments of principal, and the cost of managing the debt i.e. loans fund expenses. The amount contained in each settlement to fund these debt costs is known as Loan

Charge Support (LCS), and is paid to local authorities as part of the General Revenue Grant.

11. Local authorities may choose to borrow more than the notional amount of capital expenditure supported by the Scottish Government. This is known as self-financed borrowing.

12. The notional amount of any new capital expenditure which the Scottish Government may support in any settlement must be reflected in the Scottish Government's capital Departmental Expenditure Limits (DEL) budget. As it requires budget cover, it is already subject to HM Treasury controls. As such any UK national limit on local authority borrowing will only apply to the self-financed borrowing element of local authority borrowing.

***Statutory power to impose a borrowing limit***

13. In Scotland, powers are conferred on Scottish Ministers by the Local Government in Scotland Act 2003 section 36(1), which provides for the Scottish Ministers to impose, by order, the maximum amounts which local authorities may allocate to capital expenditure, or by direction the maximum amounts a particular local authority may allocate to capital expenditure. Use of this power would not easily achieve the desired effect of reducing borrowing as other funding is also used to finance capital expenditure. Therefore, an administrative arrangement with local authorities is to apply to ensure the borrowing by local authorities in Scotland does not exceed the limit set for Scotland by the UK Government.

14. The Scottish Government is required to monitor local authority borrowing on an on-going basis and, during the period of any national limit on borrowing, notify HM Treasury at the earliest opportunity if there was any risk that the Scottish share of any limit is likely to be breached. The Scottish Government will need to meet any breach in their share of the national limit through their own budgets in the subsequent year. This may in turn have to be passed on to the local authorities through reduced resources in their finance settlement.

15. Local authorities that stay within their allocated borrowing limits (adjusted to reflect any trading of limits agreed) will not be penalised should the all Scotland limit be breached. For those authorities that do breach their limit, it will be for Scottish Ministers to determine what action will be taken, taking into consideration the reasons for any breach.

16. In principle, a national limit could be set at any time during any financial year, subject to HM Treasury advising the devolved Administrations that a UK limit is necessary. Such a limit could then apply for one or more years. While the imposition of a national limit is not normal practice, our working assumption is that, if ever used, any limit would most likely be set in advance and apply to the following financial year only.

17. Although a limit could be imposed at any time it is assumed that any announcement would tie in with pre-budget or budget statements (in November or March). While the Scottish Government does not have direct control over the timing

of any limit (as any decision to impose a UK national limit would be taken by HM Treasury), we do maintain a regular dialogue with HM Treasury colleagues and would expect advance notification of such an intention.

18. The following section outlines the procedure that will be followed in the event of a national limit being introduced.

**Protocol**

19. The Scottish Government undertakes to inform all Scottish local authorities, and the Convention of Scottish Local Authorities (COSLA), as soon as we are advised of any decision by HM Treasury to introduce a UK national limit on local authority borrowing. The share of the UK limit that will apply to Scotland will also be advised when known.

20. For the purposes of this protocol, 'local authorities' include the 32 councils, the Tay and Forth Road Bridge Authorities, the Regional Transport Partnerships and the Valuation Joint Boards.

21. The timetable for setting individual authority allocations will be dependent on the notice period given by HM Treasury. The Scottish Government will set out, and then circulate a timetable as soon as possible after any notification is received.

22. For the purposes of this protocol 'borrowing' is advances from the loans fund made in the financial year to which the borrowing limit applies. This is the **gross** value of advances made in the year and not the net position (advances less any repayments made). Borrowing also includes other credit arrangements (other long term liabilities) which are used to finance capital expenditure, but only where the liability would be recognised on balance sheet applying ESA 95.

23. The limit on borrowing will therefore apply to the following:

- The gross value of advances from the loans fund to finance General Fund capital expenditure;
- The gross value of advances from the loans fund to finance HRA capital expenditure;
- The gross value of advances from the loans fund to finance grants or loans to third parties for capital expenditure (borrowing to fund these may only be undertaken where Scottish Ministers have provided their consent to this borrowing)
- Long term liabilities recognised in the year which finance capital expenditure such as PPP/ PFI or similar arrangements, but only where these arrangements would be on-balance sheet if ESA 95 is applied;
- Any finance lease liability recognised in the year to finance capital expenditure, and;
- Any net increases in the external borrowing of local authority subsidiaries.

24. The methodology for allocating the Scottish share of a national limit will use the latest validated capital return information available to the Scottish Government.

25. The initial allocation of the borrowing limit for each local authority will be determined as a proportion of the limit to be applied. Proportions will be calculated based on the proposed borrowing for each local authority as extracted from the capital return, adjusted for any borrowing which will not be the subject of any limit. The borrowing not subject to the limit will be limited to borrowing by local authorities for costs, such as equal pay, where the borrowing, and limits to that borrowing, has been agreed with the UK Government. See Annex A for a table showing the data to be collected and the calculation made to allocate a borrowing limit.

26. The Scottish Government will undertake an exercise to determine the validity of the forecast data used based on previous forecasts and actual outturn. If the current forecast for any particular authority appears likely to be inaccurate based on historical trends, the Scottish Government reserves the right to apply a correction factor. It is recognised that there may be some large one-off projects that could justify any substantial increases at an individual authority level. Changes to allocations based on forecast total borrowing would only be made if there was a significant deviation from historical trends that could not be justified by the relevant authority. Any corrections applied will be published as part of the initial allocation paperwork.

27. Only self-financed borrowing will be the subject of a national limit. Where the settlement for any year includes supported borrowing it is recognised that allocations based on borrowing may result in an individual authority's limit being below its supported borrowing allocation. Local authorities have acknowledged that this may be the result and accept that in such cases supported borrowing allocations as advised in Finance Circulars may not be taken up. Actual LCS allocations will not be affected, with local authorities continuing to receive LCS in line with Finance circulars.

28. These initial allocations will be circulated to all local authorities, including COSLA, to allow local authorities to make representations to the Scottish Government as to whether their allocation will cause any particular hardship. This will allow local authorities to assess their contractual commitments and any other factors that may lead to an inability to manage to the limit being proposed.

29. It is recognised that, under the Prudential Code, local authorities have the ability to borrow in advance of need. The Scottish Government does not consider that such advance borrowing should be taken into account as part of any hardship case. Whilst we recognise that there is likely to be a breach of the prudential indicators or limits, which may give rise to audit comment, the local authority should be able to justify its position. Local authorities will be required to report to the Scottish Government if they have already borrowed more than their allocation.

30. The Scottish Government will consider hardship cases presented but cannot guarantee additional allocations as this will be dependant on whether other local authorities have indicated that they will not fully require their allocations.

31. Following a consultation period, the Scottish Government will inform local authorities of their individual allocations. Local authorities will then be required to

undertake any required adjustments to their budgets and borrowing plans in order to comply with their limit.

32. For clarity, a local authority borrowing limit will include borrowing for both the General Fund and Housing Revenue Account, and any borrowing undertaken by a local authority through a controlled company. The Scottish Government will only allocate a total allocation for each local authority. It will be for a local authority to determine how much of its allocated borrowing limit will be available to the General Fund, HRA and controlled companies. A controlled company is one which is included within a local authority's Group Accounts as a Subsidiary or Joint Venture. Definitions of subsidiary and joint venture are as set out in the CIPFA/LASAAC 'Code of Practice on Local Authority Accounting in the United Kingdom: A Statement of Recommended Practice).

33. To ensure full use of any Scottish limit, local authorities agree, during the duration of any limit, to advise the Scottish Government at the earliest opportunity of any significant change in their borrowing requirements for their planned capital programme. Where this results in an authority's share of the national limit being greater than the borrowing it is actually planning, it will be possible to transfer the unused allocation to another authority, by mutual agreement.

34. The Scottish Government agrees to act as 'broker' in re-allocating any borrowing limits not required by local authorities. Any re-allocation may require the beneficiary authority to release the same amount back to the contributing authority in the following year, should a limit be in place for more than one year.

**Distribution of any National Limit**

35. The notification of each local authority's share of the Scottish limit on borrowing will be issued via a Finance Circular, which will set out:

- the distribution methodology used;
- the initial allocation to individual authorities, any adjustments made for each local authority as a result of representations made on binding contractual commitments or other representations made, and the resulting final allocation; and
- guidance on how trading of any unused allocations will be managed during the national limit period.

Local Government Division
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Example Table of Data Required and Calculations to Determine Individual Authority Allocations

| Local Authority | GF Advances from loans fund | HRA Advances from loans fund | GF Advances from loans fund – consented borrowing | HRA advances from loans fund – consented borrowing | Finance Leases | PPP/PFI or similar arrangements | LA Total Borrowing (excl. controlled companies) | Controlled Company Gross Borrowing at start of year | Controlled Company Gross Borrowing at end of year | Net movement in controlled company borrowing | LA Total Borrowing (incl. controlled companies) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| A | B | C | D | E | F | G | H | I | J | K | L |
| | Note 1 | Note 2 | Note 3 | Note 3 | Note 4 | Note 5 | Calculation Sum (B:G) | Note 6 | Note 6 | Calculation J-I Note 7 | Calculation H+K |
| Aberdeen City | | | | | | | 0.000 | | | 0.000 | 0.000 |
| ↓ | | | | | | | | | | | |
| West Lothian | | | | | | | 0.000 | | | 0.000 | 0.000 |
| LA Total | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 |
| | | | | | | | | | | | |
| Other LA - A | | | | | | | 0.000 | | | 0.000 | 0.000 |
| ↓ | | | | | | | | | | | |
| Other LA - Z | | | | | | | 0.000 | | | 0.000 | 0.000 |
| All Scotland Total | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 |

If LA borrowing (L) exceeds Scottish LA borrowing limit the initial allocation will be:
(Scottish borrowing limit + Supported borrowing) multiplied (x) by percentage share of individual share of LA Borrowing, where the percentage share of borrowing is LA borrowing (L) divided (/) by total LA borrowing (L)

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| Note 1 | Gross advances from the loans fund for non-HRA capital expenditure - taken from latest validated capital return |
| Note 2 | Gross advances from the loans fund for HRA capital expenditure – taken from latest capital return (all self-financed as no Scottish Government support for HRA borrowing) |
| Note 3 | Consented borrowing for grants or loans to third parties to fund capital expenditure |
| Note 4 | Assets acquired under finance leases in year – figures from latest capital return |
| Note 5 | Assets acquired by PPP/PFI or similar arrangements in year - figures from latest capital return but each authority asked to confirm ESA 95 status. Scottish Government to adjust based on ESA 95 assessment |
| Note 6 | Values for Controlled Company borrowing at start and end of each financial year taken from latest final capital return – local authorities may be required to provided updated values |
| Note 7 | Manual correction made if net movement in controlled company borrowing is negative – negative amounts will be set to zero. |